# Office of Chief Counsel Internal Revenue Service

# memorandum

CC:LM:RFPH:CHI:1:POSTF-152324-01 JMCascino

date: December 21, 2001

to:

Team Coordinator, LMSB:CTM:

subject: ("Taxpayer")

Taxable Years and and

LILO Transactions

Request for Advisory Opinion

This memorandum responds to your written request for advice which we received on August 24, 2001 as supplemented by your memorandum dated August 27, 2001, your email dated December 5, 2001, email dated December 6, 2001, email dated December 12, 2001 and Notices of Proposed Adjustment (Forms 5701) received by our office on December 18, 2001. The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us.

This advice is subject to National Office review. We will contact you within two weeks of the date of this memorandum to discuss the National Office's comments, if any, about this advice. This memorandum should not be cited as precedent. We have coordinated our advice with Leasing/Technical Industry Counsel Diane R. Mirabito. Ms. Mirabito concurs with our advice set forth below.

#### **ISSUES**

- 1. Under the facts as set forth below, whether the Taxpayer's claimed interest expense and rental expense deductions resulting from four Lease In Lease Out ("LILO") transactions should be disallowed because the LILO transactions lacked economic substance.
- 2. Under the facts as set forth below, whether the Taxpayer should report accrued rental income resulting from the LILO transactions.

- 3. Under the facts as set forth below, whether the Taxpayer's gross income should be increased as a result of the Taxpayer's failure to report Original Issue Discount ("OID") income.
- 4. Under the facts set forth below, whether the I.R.C. § 6662(a) accuracy related penalty should be asserted with respect to any underpayment attributable to the disallowance of the Taxpayer's net deductions resulting from the LILO transactions.
- 5. Whether the I.R.C. § 6701 penalty should be asserted against the law firms who reviewed the deals.
- 6. Whether

  (""), the tax exempt entity who sold the tax
  benefits at issue to the Taxpayer, is liable for a deficiency in
  the tax on unrelated business income under I.R.C. § 511.

#### CONCLUSION

- 1. Under the facts as set forth below, the Taxpayer's claimed interest expense and rental expense deductions resulting from four LILO transactions should be disallowed because the LILO transactions lacked economic substance.
- 2. Under the facts as set forth below, the Taxpayer should not report accrued rental income resulting from the LILO transactions because the LILO transactions lacked economic substance.
- 3. Under the facts as set forth below, the Taxpayer's gross income should be increased as a result of the Taxpayer's failure to report OID income resulting from the LILO transactions.
- 4. Under the facts set forth below, the I.R.C. § 6662(a) accuracy related penalty should be asserted with respect to any underpayment attributable to the disallowance of the Taxpayer's net deductions resulting from the LILO transactions.
- 5. I.R.C. § 6701 penalty can not be asserted against the law firms who reviewed the deals as part of the audit of the Taxpayer. The I.R.C. § 6701 can only be asserted after an I.R.C. § 6701 investigation establishes that a particular person is liable for the penalty. If you believe that any of the law firms who reviewed the deals may have violated I.R.C. § 6701, you should provide the relevant information to your 6700/7408 coordinator to determine if an I.R.C. § 6701 investigation should

be commenced against any of the firms which reviewed the deals. See IRM 120.1.6.6 for a detailed discussion regarding the procedures for conducting an I.R.C. § 6701 investigation and the facts necessary to establish that a person is liable for the I.R.C. § 6701 penalty.

6. We understand that you have raised this question with Exams' Tax Exempt and Government Entities ("TEGE") Division which in turn has submitted this question to Counsel's TEGE Division for advice. Accordingly, you will be receiving separate advice from Counsel's TEGE Division through Exam's TEGE Division with respect to this question.

#### FACTS

The is a U.S. Corporation.

(" ") is a wholly owned, domestic
subsidiary of the pears and the pears are pears are pears and the pears are pears and the pears are pe

During the taxable year , entered into four LILO transactions with . In your request for advice dated August 24, 2001, you forwarded a draft Explanation of Adjustment with respect to each of the four LILO transactions for our review. In the draft Explanations of Adjustments, you have referred to these LILO transactions as " ", " and " "."

On \_\_\_\_\_\_, you conducted an unsworn investigative interview of \_\_\_\_\_\_, you conducted an unsworn investigative interview of \_\_\_\_\_\_, you conducted an unsworn investigative interview of \_\_\_\_\_\_, ("\_\_\_\_\_\_"), a vice-president of \_\_\_\_\_\_. Each of these interviews was transcribed by a Court Reporter. The purpose of these interviews was to further develop the facts related to the LILO issues and, in particular, to determine the applicability of the negligence penalty.

Pursuant to our oral advice, you subsequently prepared and emailed to our office on December 5, 2001, December 6, 2001 and December 12, 2001 draft Explanations of Adjustments asserting OID income and the negligence penalty with respect to the LILO transactions. On December 18, 2001, you hand delivered to our

<sup>&</sup>lt;sup>1</sup> For security purposes, you changed the Taxpayer's name on these draft Explanations of Adjustments.

office for review Forms 5701 disallowing the claimed rental and interest deductions, asserting OID income and asserting the negligence penalty with respect to the LILO transactions. You orally indicated that you had recently issued these Forms 5701 to the Taxpayer and that you expected to issue a Revenue Agent's Report incorporating these Forms 5701 to the Taxpayer on or about the end of January 2002.

For purposes of this memorandum, we have assumed that the facts regarding the four LILO transactions at issue are as set forth in the Forms 5701 and have incorporated those facts herein by this reference. We have summarized below the facts related to the LILO.

### Α.

remaining years of the Headlease.

has historically owned and used certain property having a total a remaining useful life of years and an appraised fair market value of \$ (per Appraisal, ).
( ) (" ") is the Lender and ( ) Limited (" ") is the Defeasance Deposit Holder
or Payment Counterparty.  (" ") is the Equity Deposit Holder and Provider of the Letter of Credit.  the ultimate parent of the Lender and Deposit Takers and is also a guarantor for some of these.
On or about , and entered into a LILO transaction under which leased the property vehicles (model vehicles (model property back to under a Sublease. The term of the Headlease is years ending term of the Sublease is years. Moreover, as described below, the Sublease may also have a "put renewal" term of years.
The Headlease requires to make two rental payments to : (1) a \$ prepayment" at the beginning of year 1; and (2) a "postpayment" at the end of year of \$ prepayment. For federal income tax purposes, and allocate the prepayment ratably to the first years of the Headlease and the future value of the postpayment ratably to the

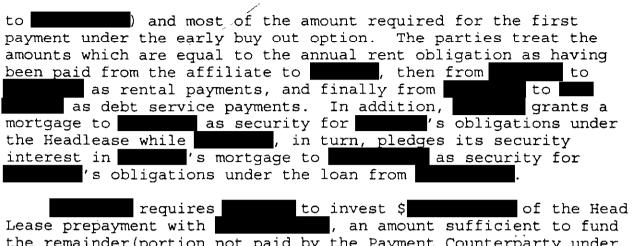
The Sublease requires to make fixed, annual rental payments over both the primary term and, if exercised, the put renewal term. The fixed, annual payments during the put renewal

term are substantially higher than those for the primary term. For example, the rent increases by \*\* from the last year of the primary term to the first year of the put renewal term. Nevertheless, the fixed, annual payments during the put renewal term are projected to not exceed \*\*\* percent of the fair rental value of the Equipment over the Renewal Lease Term.

At the end of the Sublease primary term, "fixed-payment option" to purchase from \_\_\_\_\_ the Headlease residual (the right to use the property beyond the Sublease primary term subject to the obligation to make the rent postpayment) for a fixed amount. If exercises the option, the transaction is terminated at that point and is not required to make any portion of the postpayment due under the Headlease. If does not exercise the option, may elect to (1) use the property itself for the remaining term of the Headlease, (2) lease the property to another person for the remaining term of the Headlease, or (3) compel lease the property for the years put renewal term of the Sublease. If does not exercise the fixed-payment option and exercises its put renewal option, can require to purchase a letter of credit guaranteeing the put renewal rents. If does not obtain the letter of credit, must exercise the fixed-payment option.

To partially fund the \$ \_\_\_\_\_\_ Headlease prepayment, borrows \$ \_\_\_\_\_ from \_\_\_\_\_. The loan is nonrecourse, has a fixed interest rate of \_\_\_\_\_\_ %, and provides for annual debt service payments that fully amortize the loan over the \_\_\_\_\_\_ -year primary term of the Sublease. The amount and timing of the debt service payments mirror the amount and timing of the Sublease payments due during the primary term of the Sublease.

Upon receiving the \$ Headlease prepayment at closing, makes two payments: 1) makes an irrevocable and non-refundable payment of \$ , an affiliate of ...... In consideration of this payment or deposit, provides the with an Irrevocable Letter of Credit in the aggregate available amount of to be paid out on the same days as the required payments under the early buyout schedule; and 2) makes an irrevocable, and, non-refundable 'Upfront Fee' payment of \$ to , the "Payment Counterparty", an affiliate . The 'Upfront Fee', with \_\_\_\_\_, earns interest at the same rate as the loan from \_\_\_\_\_. The Payment Agreement calls for \_\_\_\_\_ to pay \_\_\_\_ annual amounts equal to . The Payment Agreement 's annual rent obligation under the Sublease (that is, amounts sufficient to satisfy 's debt service obligation

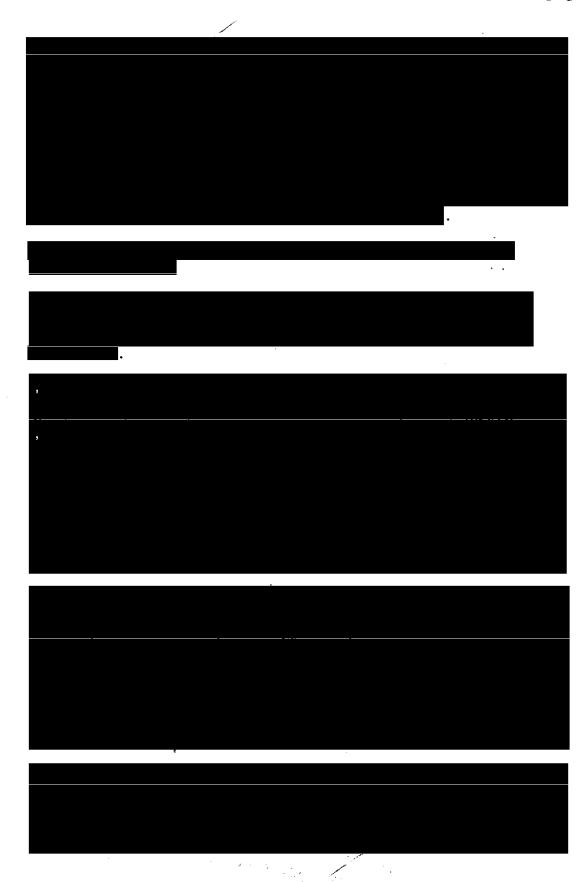


the remainder (portion not paid by the Payment Counterparty under the Payment Agreement) of the fixed amount due under the fixed-payment option, and to obtain an Irrevocable Letter of Credit to Having economically defeased both its rental obligations under the Sublease and its fixed payment under the fixed-payment option, keeps the remaining portion of the Headlease prepayment, approximately \$ \_\_\_\_\_\_\_, as its return on the transaction.

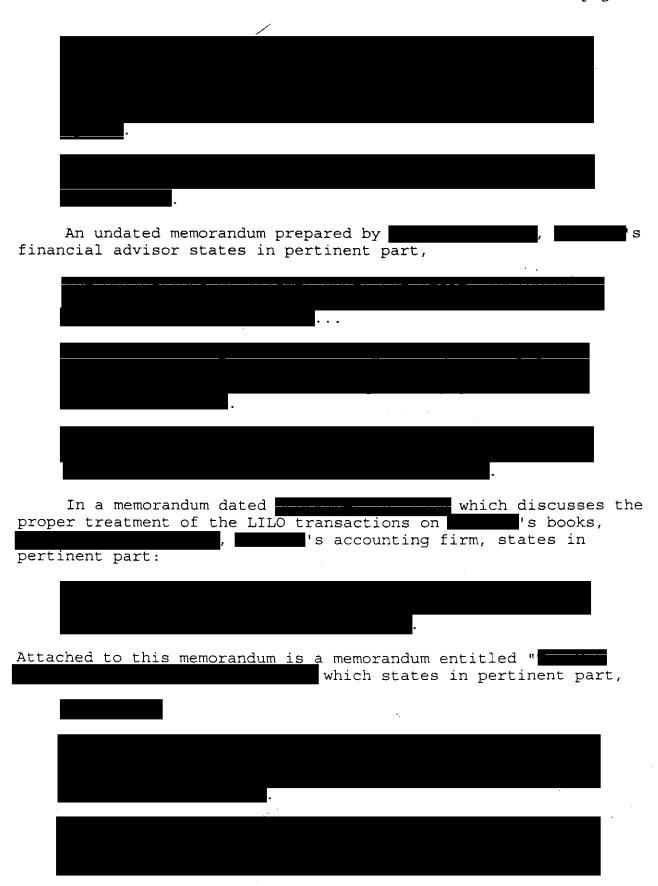
For tax purposes, claims deductions for interest on the loans and for the allocated rents on the Headlease. includes in gross income the rents received on the Sublease and, if and when exercised, the payment received on the fixed payment option. By accounting for each element of the transaction separately, purports to generate a stream of substantial net deductions in the early years of the transaction followed by net income inclusions on or after the conclusion of the Sublease primary term. As a result, anticipates a substantial net after-tax return from the transaction. also anticipates a positive pre-tax economic return from the transaction. However, this pre-tax return is insignificant in relation to the net after-tax return.

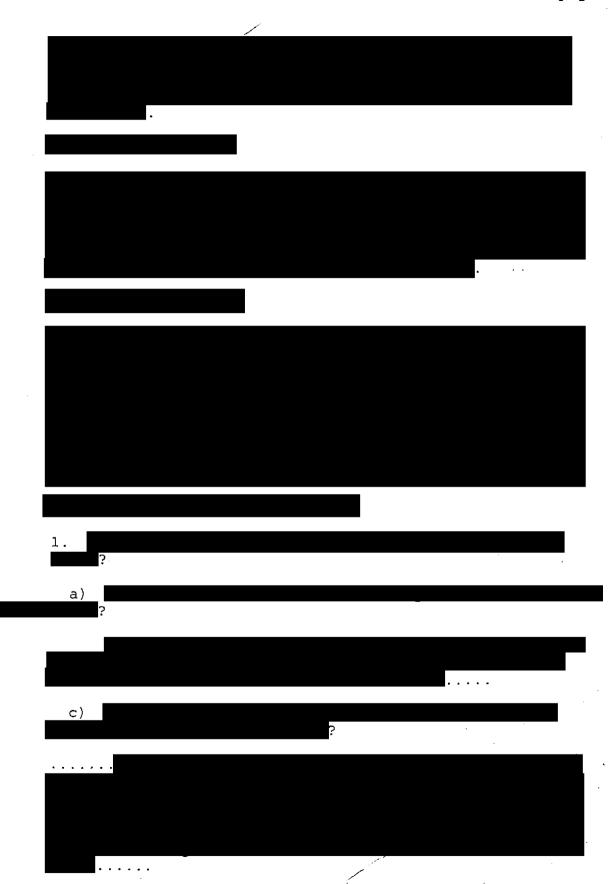
In addition to the facts set forth above which are included in the draft Explanation of Adjustments which you forwarded to us with your request for advice dated August 24, 2001 and on the Forms 5701, the Forms 5701, documents which you have provided to us and your subsequent interviews of and indicate additional facts which we believe should be mentioned herein. These facts are as follows:

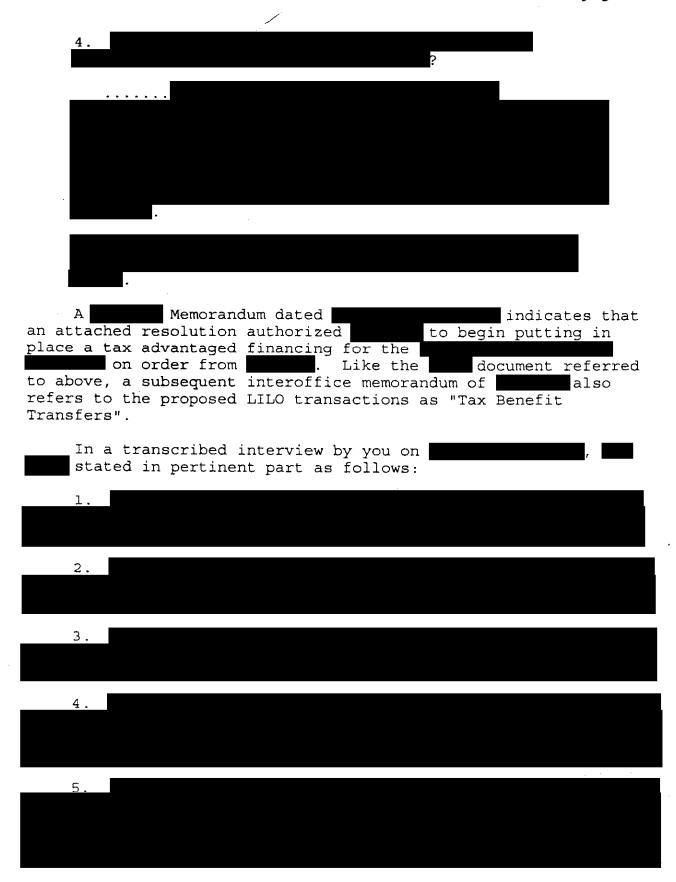
A Taxpayer Interoffice Memorandum dated addressed to the states, in pertinent part, the following with respect to the proposed LILO transaction with ,



In their interviews, and and indicated that they prepared the above-quoted Interoffice Memorandum.
A Taxpayer Interoffice Memorandum dated  addressed to and from and and states, in pertinent part, the following with respect to the proposed LILO transaction with
A Taxpayer Interoffice Memo to  dated restates word for word the above italicized quotes from the Taxpayer Interoffice Memo dated and, in comparing the LILO to the "traditional" leveraged lease, further states in pertinent part,





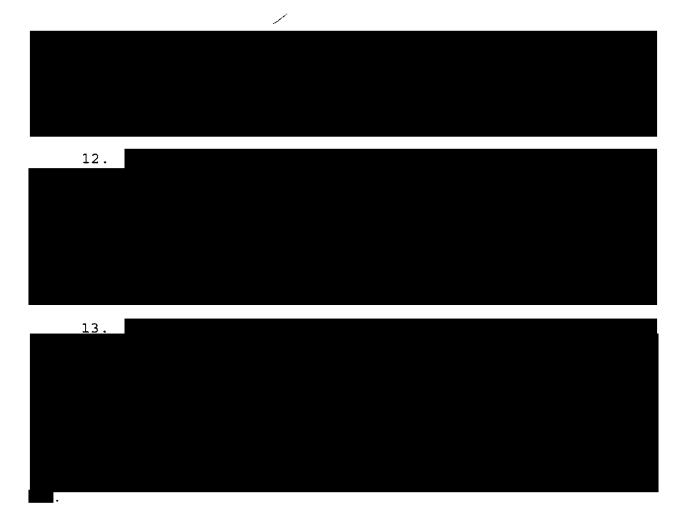


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In a	a transcribed interview by you o ated in pertinent part as follow	n marini, marini
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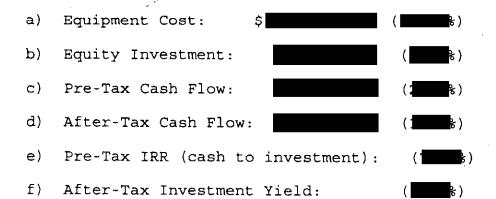
8. 10. 11.



In response to an Information Document Request, vice president and Director of Corporate Tax of the Taxpayer, stated the following:

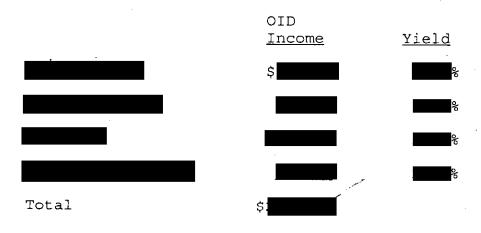


In a letter to you dated , represented that the following economic profit analysis indicated that the LILO transactions had economic substance other than tax benefits:



In your memorandum to our office dated August 24, 2001, you stated that the Taxpayer's economic analysis is flawed because the Taxpayer's analysis assumes that renews the lease while the aforementioned facts show that was extremely unlikely to renew the lease. You have represented that the Taxpayer calculated a return for the initial term of each lease %, %, %, and %, respectively. You orally indicated that each of these Taxpayer calculated returns assumed exercises its purchase option, but did not take into account fees paid by the Taxpayer or the Taxpayer's cost of capital. Form 5701 indicates that borrowed the Equity Payment for each LILO transaction from its , through a line of credit at rates ranging from Your orally indicated that the facts regarding the interest rate on the line of credit was received from the Taxpayer in response to an Information Document Request and that the response stated that the interest rate on the line of credit fluctuated weekly.

By emails dated December 5, 2001 and December 6, 2001, you forwarded to our office OID calculations and an OID report in which you determined that the Taxpayer should report OID income for the taxable year resulting from the LILO transactions as follows:



Your analysis assumes that will elect to exercise its repurchase option at the end of the initial term of each lease. This report forms the basis of the OID Form 5701.

By email dated December 12, 2001, you forwarded to our office a Penalty report in which you determined that the Taxpayer is liable for the negligence penalty with respect to the underpayment attributable to the LILO transactions. This report forms the basis of the Form 5701 for the negligence penalty. Because the underpayment attributable to the LILO transactions is less than the substantial understatement penalty is not applicable.

B. and

## **DISCUSSION**

In general, a transaction will be respected for tax purposes if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by taxavoidance features that have meaningless labels attached." Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978); James v. Commissioner, 899 F.2d 905, 908-09 (10th Cir. 1990). In assessing the economic substance of a transaction, a key factor is whether the transaction has any practical economic effect other than the creation of tax losses. Courts have refused to recognize the tax consequences of a transaction that does not appreciably affect the taxpayer's beneficial interest except to reduce tax. The presence of an insignificant pre-tax profit is not enough to provide a transaction with sufficient economic substance to be respected for tax purposes. Knetsch v. United <u>States</u>, 364 U.S. 361, 366 (1960); <u>ACM Partnership v.</u> Commissioner, 157 F.3d 231, 248 (3d Cir. 1998); Sheldon v. Commissioner, 94 T.C. 738, 768 (1990).

Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985), is a pivotal case in defining sham transactions under the rationale of <u>Frank Lyon</u>. Significant to the present case, the Fourth Circuit affirmed the Tax Court in finding an equipment

sale leaseback a sham. Under the test formulated, a transaction is a sham if (1) it is not motivated by any economic purpose outside of tax considerations, and (2) it is without economic substance because no real potential for profit exists.

In determining whether a transaction has sufficient economic substance to be respected for tax purposes, courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. For example, in <a href="Knetsch">Knetsch</a>, the taxpayer purchased an annuity bond using nonrecourse financing. However, the taxpayer repeatedly borrowed against increases in the cash value of the bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon, the Tax Court denied the taxpayer the purported tax benefits of a series of Treasury bill sale-repurchase transactions because they lacked economic substance. transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills. The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. The transactions lacked economic substance because the economic consequences of holding the Treasury bills were largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon at 769.

In <u>ACM Partnership</u>, the taxpayer entered into a near-simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position." <u>ACM Partnership</u> at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had a large tax effect resulting from the application of the installment sale rules to the sale. The court held that transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. <u>ACM Partnership</u> at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other

than the creation of tax benefits.

Relying upon the aforementioned case law, in Revenue Ruling 99-14, 1999-13 I.R.B. 3 (1999), the Service ruled that a domestic corporation could not deduct interest or prepaid rent incurred in connection with a LILO transaction with a foreign municipality that lacked economic consequences other than tax benefits. Under the facts set forth in Revenue Ruling 99-14, the corporation's obligations under the sublease it granted were completely offset by its rights under the lease it received. Moreover, its obligations to make debt service payments on the loans used to acquire the lease were completely offset by rents received on the sublease, and the risks of nonpayment on the loan and the sublease were defeased by similarly circular pledges of security. Finally, the corporation's exposure to the lease residual was rendered insignificant by the municipality's option to purchase that residual and a pledge of securities that defeased the foreign municipality's option payment. The only real economic consequence of the LILO transaction was the corporation's pre-tax return on the sublease, which was too insignificant, when compared to its after-tax yield, to support a finding that the transaction had significant nontax consequences.

We have reviewed your analysis of each of the four LILO transactions in this case. We agree with your analysis that each of the four LILO transactions closely resemble the LILO transaction set forth in Revenue Ruling 99-14. Based upon Revenue Ruling 99-14 and the legal authorities cited therein, we agree with your conclusion that the interest expense and rental expense deductions resulting from four LILO transactions should be disallowed because the LILO transactions lack economic substance.

With respect to the transaction, we agree with your analysis that, viewed as a whole, the objective facts of the LILO transaction indicate that the transaction lacks the potential for any significant economic consequences other than the <u>creation</u> of tax benefits. As in Revenue <u>Ruling 99-14</u>, during -year primary term of the Sublease, obligation to make the property available under the Sublease is completely offset by 's right to use the property under the Head Lease. 's obligation to make debt service payments on the loans from is completely offset by 's right to receive Sublease rentals from Moreover, 's exposure to the risk that make the rent payments is further limited by the arrangements with the affiliates of , and . In the case of the loan from economic risk is completely eliminated through the defeasance

arrangement. As a result, the bank does not require an independent source of funds to make the loans, nor does it bear significant risk of nonpayment. In short, during the Sublease primary term, the offsetting and circular nature of the obligations eliminate any significant economic consequences of the transaction.

At the end of the -year Sublease primary term, will have either the proceeds of the fixed-payment option or a Head Lease residual that has a fair market value approximately equal to the proceeds of the fixed payment option. If, at the end of the -year Sublease primary term, the Head Lease residual is worth more than the payment required on the fixedpayment option, will capture this excess value by exercising the fixed payment option, leaving with only the proceeds of the option. Conversely, if, at the end of the -year Sublease primary term, the Head Lease residual is worth significantly less than the payment required on the fixedpayment option, will put the property back to under the put renewal option at rents, that while initially projected to be at only percent of estimated fair market value, are (because of the decline in the value of the property) greater than fair market value. Thus, as in Revenue Ruling 99-14, the fixed payment option and put renewal option operate to "collar" the value of the Head Lease residual during the primary term, limiting much of the economic consequence of the Head Lease residual.

As in Revenue Ruling 99-14, the facts indicate that there is 's credit under the fixed-payment option and, if exercised, the put renewal term. At the inception of the transaction, was required to use a portion of the Head Lease prepayment to purchase a guaranteed Letter of Credit that was pledged to , ensuring 's ability to make the payment under the fixed-payment option. If does not exercise the fixed-payment option and exercises the put renewal option, can require to purchase a letter 's obligation to make the put

If does not obtain the letter of credit guaranteeing renewal rent payments. If does not obtain the letter of credit, must exercise the fixed-payment option. Thus, as a practical matter, the transaction is structured so that is never subject to 's credit.

Due to a typographical error, the Form 5701 incorrectly states \*\* instead of \*\*\*. We recommend that you correct this error and provide the Taxpayer with a corrected copy of the page containing this error.

Your conclusion that the LILO transaction is structured so is <u>never subject to see so</u>'s credit is further supported by the Interoffice Memos dated and (see italicized quotations in Facts section above) and your interview of interview of stated that he did not view 's risks with respect to the LILO transactions as significant. As in Revenue Ruling 99-14, the conclusion that insulated from any significant economic consequence of the Head Lease residual is further supported by several factors indicating that the parties expect to exercise the fixed-payment option. First, has historically used the property. Second, because the fixed payment obligation is fully defeased, need not draw on other sources of capital to exercise the option. However, if does not exercise the fixed payment option and exercises the put renewal option, would be required to draw on other sources of capital to satisfy its put renewal rental obligations. Statements from various documents of and quoted in the Facts section above further indicate that the parties to the LILO transactions envisioned that the likelihood of failing to exercise its purchase option was extremely remote. While the likelihood of exercising its purchase option is questioned in the Taxpayer's Interoffice Memorandum dated and by and in their interviews, in our view, the preponderance of the evidence as indicated by the economics of the LILO transaction and the statements in the above-quoted documents demonstrate that, at the time entered into the LILO transaction, the likelihood of failing to exercise its purchase option was extremely remote. this regard, the subsequent Taxpayer Interoffice Memo dated reiterates that the Taxpayer firmly believed that the likelihood of failing to exercise its purchase option is extremely remote. (See italicized quotations from Memo repeated in Memo in Facts section above) Like the LILO transaction described in Revenue Ruling 99-14, the LILO transaction herein lacks the potential for significant economic consequences other than the creation of tax benefits. During the primary term of the Sublease, s obligations to provide property are completely offset by its right to use property. sobligations to make debt service payments on the loans are completely offset by service payments

rent on the Sublease. These cash flows are further assured by

the deposit arrangements with the affiliates of

On Form 5701 you conclude that, as in Revenue Ruling 99-14, 's pre-tax return is too insignificant, when compared to 's after-tax yield, to support a finding that the transaction has significant economic consequences other than the creation of tax benefits. Assuming that the Taxpayer's after tax yield is \coloredge{k-100}, pre-tax yield is \coloredge{k-100}, and cost of capital is \coloredge{k-100}, we agree with your conclusion that, as in Revenue Ruling 99-14, \coloredge{k-100}, by pre-tax return, if any, is too insignificant, when compared to \coloredge{k-100}, safter-tax yield, to support a finding that the transaction has significant economic consequences other than the creation of tax benefits. Rice's Toyota World, Inc., supra.

The documents which you provided and your interview of further indicate that the LILO transactions were not motivated by any economic purpose outside tax considerations. a memorandum dated which discusses the proper treatment of the LILO transactions on 's books, 's accounting firm, states that "the purpose transaction is to transfer the tax benefits of the property from to a third party" ( Like memorandum, a interoffice memorandum also refers to the proposed LILO transactions as "Tax Benefit Transfers". In his interview, \_\_\_\_\_ stated that tax benefits were a "key factor" in any leveraged lease transaction and that wouldn't enter into any leveraged lease based on the pre-tax return alone because an integral part of any lease transaction is some of the tax benefits which contribute to 's rate of return.

As in Revenue Ruling 99-14, some of the features of the LILO transaction discussed above are present in transactions that the Service will respect for federal income tax purposes. For example, an arrangement for "in-substance defeasance" of an outstanding debt was respected in Rev. Rul. 85-42, 1985-1 C.B. 36. By contrast, in the LILO transaction, the deposit arrangement exists from the inception of the transaction, eliminating any need by for an independent source of funds. Similarly, other features of the LILO transaction, such as nonrecourse financing and fixed-payment options, are respected in other contexts. However, when these and other features are viewed as a whole in the context of the LILO transaction, these

features indicate the LILO transaction should not be respected for tax purposes. As a result of the LILO transaction lacking economic substance, the Taxpayer may not deduct rent, interest, or fees paid or incurred in connection with the LILO transaction.

- 2. When deductions are disallowed because a transaction lacks economic substance, income attributable to the transaction is eliminated as well. Sheldon, 94 T.C. at 762; Leema Enterprises v. Commissioner, T.C. 1999-18; ACM Partnership, 157 F.3d at 261. Sheldon held that certain repurchase transactions were shams and, therefore, the taxpayer should not be required to include income on the Treasury bills financed by those agreements. Similarly, in Leema Enterprises, the court did not require the taxpayer to recognize the income from gains from straddles that lacked economic substance, when it had held that the deductions from the losses on the straddles should be disallowed. Accordingly, the Taxpayer should not report accrued rental income resulting from the LILO transactions because the LILO transactions lacked economic substance.
- 3. A sham transaction may contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded. Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4<sup>th</sup> Cir. 1985); ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998). Section 1272(a)(1) provides as follows:
  - (a) Original issue discount on debt instruments issued after July 1, 1982, included in income on basis of constant interest rate.
  - (1) General rule. For purposes of this title, there shall be included in the gross income of the holder of any debt instrument having original issue discount issued after July 1, 1982, an amount equal to the sum of the daily portions of the original issue discount for each day during the taxable year on which such holder held such debt instrument.

Sections 1273(a)(1) and (a)(2) provide as follows:

- (a) General rule.
  For purposes of this subpart-
- (1) In general. The term original issue discount" means the excess (if any) of-
- (A) the stated redemption price at maturity, over

- (B) the issue price.
- (2) Stated redemption price at maturity. The term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time (other than any interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument).

Based on the cases cited, we agree with your conclusion that the initial "equity payment", from to to have real economic effect and should be respected for income tax purposes. Accordingly, we further agree with your conclusion that the Taxpayer's gross income should be increased as a result of the Taxpayer's failure to report OID.

4. In your memorandum you indicated that the substantial understatement penalty of I.R.C. § 6662(b)(2) is not applicable to the underpayment for the taxable year because the underpayment for the taxable year will not exceed the greater of of the tax required to be shown on the Taxpayer's return or \$ Accordingly, whether the I.R.C. Sec. 6662(a) penalty applies to the portion of the underpayment attributable to the LILO related adjustments depends on whether the underpayment attributable to these adjustments is due to negligence or intentional disregard of the rules and regulations.

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See Internal Revenue Code § 6662(c) and Treas. Req. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff'q 43 T.C. 168 (1964); Neely v. Commissioner, 85 T.C. 934, 947 (1985). Treas. Reg. § 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. In Compag v. Commissioner, 113 T.C. 214 (1999), appeal docketed, No. 00-60648 (5th Cir. January 12, 2001), the Service argued that Compaq was liable for the accuracy-related penalty because Compag disregarded the economic substance of the transaction. The Tax Court agreed with the Service's position and asserted the accuracy-related penalty for

negligence because Compaq "failed to investigate the details of the transaction, the entity it was investing in, the parties it was doing business with, or the cash-flow implications of the transaction." 113 T.C. at 227. The Tax Court also sustained the application of the negligence penalty in <u>Sheldon v. Commissioner</u>, 94 T.C. 738 (1990), stating the taxpayer, "intentionally entered into loss-producing repos in order to generate and claim tax benefits." Thus, if the facts establish that a taxpayer reported losses from a transaction that lacked economic substance, then the accuracy-related penalty attributable to negligence may be applicable if the taxpayer failed to make a reasonable attempt to ascertain the correctness of the claimed losses or deductions.

A return position that has a reasonable basis as defined in Treasury Regulation § 1.6662-3(b)(3) is not attributable to negligence. A reasonable basis is a relatively high standard of tax reporting, one significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or colorable. A return position is reasonable where based on one or more of the authorities listed in Treas. Req. § 1.6662-4(d)(3)(iii), taking into account the relevance and persuasiveness of the authorities and subsequent developments, even if the position does not satisfy the substantial authority standard defined in Treasury Regulation § 1.6662-4(d)(2). reasonable cause and good faith exception in Treasury Regulation § 1.6664-4 may relieve the taxpayer from liability from the negligence penalty, even if the return position does not satisfy the reasonable basis standard. See Treas. Reg. § 1.6662-3(b)(3).

The accuracy-related penalty does not apply with respect to any portion of an underpayment with respect to which the taxpayer establishes that there was reasonable cause and that the taxpayer acted in good faith. I.R.C. § 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Treas. Reg. § 1.6664-4(b)(1).

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reliance on professional advice, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Treas. Reg. § 1.6664-4(b)(1). See also United States v. Boyle, 469 U.S. 241 (1985) (reasonable cause is established when a taxpayer shows that he reasonably relied on the advice of an

accountant or attorney). In this regard, Treasury Regulation § 1.6664-4(c) provides minimum requirements that the taxpayer must establish to be considered to have reasonably and in good faith relied upon on an opinion or advice as follows:

- (c) Reliance on opinion or advice- (1) Facts and circumstances; minimum requirements. All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax adviser) as to the treatment of the taxpayer or any entity, plan, or arrangement) under Federal tax law. However, in no event will a taxpayer be considered to have reasonably relied in good faith on advice unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.
- (i) All facts and circumstances considered. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or should know, to be relevant to the proper tax treatment of an item.
- (ii) No unreasonable assumptions. The advice must not be based on unreasonable factual or legal assumptions (including assumption as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.

For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate a Section 6662(a) accuracy-related

penalty, the Tax Court in <u>Neonatalogy Associates P.A. v.</u>
<u>Commissioner</u>, 115 T.C. 46 (2000) stated that the taxpayer has to satisfy the following three-prong test: (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer gave to the advisor the necessary and accurate information, and (3) the taxpayer actually relied in good faith on the adviser's judgment.

We agree that the facts indicate that, like the LILO transaction in Revenue Ruling 99-14, the LILO transactions in this case lack economic substance for reasons previously discussed. Although Revenue Ruling 99-14 had not been published at the time the LILOs were entered into by the Taxpayer, the case law had established that transactions lacking in economic substance would be disregarded for tax purposes and resulting tax deductions, losses and credits disallowed. For example, see Knetsch v. United States, 364 U.S. 361, 366 (1960); Rice's Toyota World, Inc. v. Commissioner, 752 F. 2d. 89 (4th Cir. 1985); Sheldon v. Commissioner, 94 T.C. 738, 768 (1990). Because the Taxpayer's claimed interest and rental deductions were based upon a transaction lacking in economic substance, in our view, the Taxpayer's position in claiming these deductions did not have a reasonable basis.

stated that he and reviewed the temporary Section 467 regulations and believed that the LILO transactions complied with the regulations. stated that he thought a 📲 return was sufficient based upon Revenue Procedure 75-21. admitted that the LILO transaction differed from the typical sale-leaseback transaction because obtained a leasehold interest in the assets rather than outright ownership and other leases lacked the payment undertaking agreements and deposit agreements present in the LILO transactions. As experienced leasing executives, knew or should have known that the LILO transactions lacked economic substance within the meaning of the case law existing at the time that entered into the LILO transactions and that the Section 467 regulations and Revenue Procedure 75-21 were not applicable to a transaction lacking economic substance. In addition, while Revenue Procedure 75-21 requires that the cost to finance the equity investment be taken into account, admitted that he did not take into 's cost of capital in entering into the LILO transactions and that he could not recall any tax advantaged leasing transaction where \_\_\_\_\_\_'s pre-tax rate of return was in excess of scot of capital. In his interview, stated that tax benefits were a "key factor" in any leveraged lease transaction and that wouldn't enter into any leveraged lease based on the pre-tax return alone because an

integral part of any lease transaction is some of the tax benefits which contribute to 's rate of return. of the lack of economic substance of the LILO transactions to which they were aware or should have been aware, alleged review of and reliance on the Section 457 Temporary regulations and Revenue Procedure 75-21, in our view, did not constitute a reasonable attempt to ascertain the correctness of deductions which to a reasonable and prudent person would have seemed "to good to be true" under the circumstances. Treas. Reg. § 1.6662-3(b)(3). Also, in light of the lack of economic substance of the LILO transactions to which were aware or should have been aware, we and do not believe that the Taxpayer has established that the underpayment attributable to the LILO transactions is based upon an honest misunderstanding of fact or law that was reasonable in light of all the facts and circumstances including the experience, knowledge and education of the Taxpayer. Treas. Reg. § 1.6664-4(b)(1).

Although the Taxpayer's Tax Department was responsible for the proper reporting of items on the Taxpayer's tax return, as indicated in your interviews of and and the IDR response from the Taxpayer's Tax Department did not specifically analyze the transactions, made no assumptions or inquiries with respect thereto, and provided no written or oral opinion with respect to the transactions. In our view, the Tax Department's failure to analyze the transactions for purposes of determining the correct tax reporting of items related to the transactions is a strong indicator of negligence. Treas. Reg. 1.6662-3(b)(1)(ii).

Your interviews of and and and and the IDR response of appear to indicate that the Tax Department apparently relied upon services and analysis of the tax treatment of the LILO transactions, that had obtained a tax opinion from and had received oral and that opinions over the telephone from several law firms regarding the generic LILO structure. The Taxpayer has refused to provide a tax opinion to which the Taxpayer copy of the claims to rely and the Taxpayer's representatives, <u>, have refused to</u> testify with respect to the substance tax opinion or the substance of the alleged conversations with other law firms. Because the Taxpayer has failed to produce the tax opinion and the Taxpayers' representatives have refused to testify regarding the substance of the tax opinion or the substance of the other alleged oral opinions, the Taxpayer can not even establish that it meets the minimum requirements for reasonable

reliance set forth in Treasury Regulation § 1.6664-4(c) quoted above.

and also stated that the Federal Transportation Agency had approved of domestic LILO transactions. While the Federal Transportation Agency may have approved of domestic LILO transactions, the Federal Transportation Agency had no authority to, and did not in fact, provide a ruling as to the proper treatment of domestic LILO transactions for federal tax purposes. Because and knew or should have known that the Federal Transportation Agency had no authority to, and did not in fact, provide a ruling as to the proper tax treatment of domestic LILO transactions for federal income tax purposes, the fact that the Federal Transportation Authority had approved of domestic LILO transactions fails to establish that the Taxpayer's underpayment attributable to the LILO transactions was not due to negligence and was due to reasonable cause.

For the foregoing reasons, we agree with your conclusion that the Taxpayer has failed to establish that the underpayment was due not to negligence and failed to establish that the underpayment was due to reasonable cause and that the Taxpayer acted in good faith with respect to the underpayment. Accordingly, we agree with your determination that the negligence penalty should be imposed upon the portion of the underpayment attributable to the disallowance of the net deductions from the LILO transactions.

- 5. No further discussion necessary.
- 6. Because an opinion on this issue is being rendered separately by Division Counsel (TEGE), no discussion of this issue is necessary.

In accordance with the Chief Counsel Directives Manual, we are submitting this memorandum for review by our National Office and anticipate a response from the National Office in approximately ten days. As you know the response can supplement, modify and/or reject the advice contained herein. Accordingly, please take no action on the advice contained herein until such time as we notify you as to whether or not there are any exceptions or modifications to this advice by the National Office.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions concerning this matter, please do not hesitate to call Attorney James M. Cascino at (312) 886-9225 ext. 338.

PAMELA V. GIBSON
Associate Area Counsel
(Large and Mid-Size Business)

CC: James C. Lanning, Area Counsel
Harmon B. Dow, Associate Area Counsel (IP)
Pamela V. Gibson, Associate Area Counsel
William G. Merkle, Associate Area Counsel (SL)
Barbara B. Franklin, Senior Legal Counsel (HQ)
Diape R. Mirabito, Industry Counsel